STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE

300 Capitol Mall, 16th Floor
Sacramento, California 95814

NOTICE OF PROPOSED EMERGENCY AMENDMENT PURSUANT TO CALIFORNIA INSURANCE CODE SECTION 12921.7

California Earthquake Authority Policies, Coverage Types and Limits; Additional Requirements for Offer of Optional-Limits Basic Residential Earthquake Insurance Policies

File No. ER-2006-00001 October 27, 2006

California Insurance Commissioner John Garamendi (the Commissioner) hereby provides notice pursuant to California Insurance Code section 12921.7 that he will submit for emergency amendment Title 10, Chapter 5, Subchapter 7.7, Sections 2697.6 and 2697.61 of the California Code of Regulations (10 CCR §§2697.6 and 2697.61) to the Office of Administrative Law for approval pursuant to California Government Code section 11346.1.

The emergency amendment implements, interprets, and makes specific Chapter 8.6 (commencing with section 10089.5) of Part 1 of Division 2 of the California Insurance Code [California Earthquake Authority].

This Notice includes a description of the problem that the amendment is intended to resolve, the necessity for the amendment, the justification for its emergency adoption, and a copy of the text of the emergency amendment.

This Notice will be provided to every person, group, and association who has previously filed a request for notice of all regulatory actions with the Department of Insurance (Department), as well as to every person, group, and association having filed a request to receive only notices of regulations specifically involving Property & Casualty, Rate Regulation, Discrimination and Underserved Communities.

Documents concerning this proceeding are available on the Department's website. To access them, go to http://www.insurance.ca.gov. Find, near the top of the leftmost column, the pull down menu under the heading "Quick Links." Select the "Legal Information" link. On the "Legal Information" page, click on the "Proposed Regulations" link. When the "Search or Browse for Documents for Proposed Regulations" screen appears, you may choose to find the documents either by conducting a search or by browsing for them by name.

To search, enter "ER200600001" (the Department's regulation file number for this amendment) in the search field. Alternatively, search using as your search term the California Insurance Code section number of a code section that the regulations implement (for instance, "10089.11"), or search by keyword ("earthquake," for example, or "CEA"). Then, click on the "Submit" button to display links to the various filing documents.

To browse, click on the "Browse All Regulations" button near the bottom of the screen. A list of the names of regulations for which documents are posted will appear.

Requests for hard copies of this Notice and questions regarding it should be directed to: Lisbeth Landsman-Smith, Staff Counsel, Department of Insurance, 300 Capitol Mall, Suite 1600, Sacramento, California, 95814, phone 916-492-3561, email: landsmanl@insurance.ca.gov.

This proposed emergency amendment will be submitted to the Office of Administrative Law not less than five (5) working days after the mailing of this Notice.

Description of Problem and Necessity for Regulation

The California Earthquake Authority ("CEA") writes earthquake insurance. It was established by the Legislature in response to the widespread unavailability of homeowners and earthquake insurance after the 1994 Northridge earthquake. The CEA carefully considers the purpose of its formation when shaping its fundamental objectives, one of which is increasing the availability of earthquake insurance for California renters, condominium owners, and homeowners. As a public instrumentality of the state, the CEA is governed by a board of elected state officials and managed by staff of primarily civil servants; the CEA is funded largely with private monies.

The CEA enabling statute authorizes the CEA to write basic residential earthquake insurance, and by regulation, the basic product has been divided into a "base" product (the CEA's statutory "mini-policy," "base program," or "base limits policy") and an "optional-limits" product, usually called the CEA's Supplemental Limits Program. The CEA believes that while the base limits policy is quite helpful and would cover, for example, a house and a small amount of personal property and living expenses, it has really been the Supplemental Limits Program that has driven CEA success in policy sales for several years. The CEA sees the Supplemental Limits Program as key to its ability to increase the availability of earthquake insurance for Californians.

The Supplemental Limits Program is supported almost entirely by reinsurance. In fact, for 2007, its reinsurance amounts to almost $600 million in a reinsurance contract that responds to losses in excess of the CEA's $50.3 million retention. The 2007 reinsurance program dates to February 2006, when the CEA Governing Board adopted the CEA's 2007 base program and Supplemental Limits Program financial structures and directed CEA staff to obtain reinsurance commitments consistent with those structures. The CEA immediately began the complex process necessary to obtain the reinsurance, contacting some 171 reinsurers in 15 countries for bids.

By June 2006 the CEA had obtained certain reinsurance commitments but for a smaller claim-paying capacity than in prior years. The problem was a reinsurance market growing harder by the day, spawned primarily by reinsurers' need and desire to recoup huge losses from the hurricanes of 2004 and 2005 in the Southeastern United States (Katrina, Wilma, Rita). Every insurer looking to reinsure exposure experienced the hard market, but as one of the world's very largest purchasers of property catastrophe reinsurance, the CEA acutely felt the climbing prices. Even with less reinsurance than desired, and at a considerably higher cost than desired, the reinsurance commitments included as much reinsurance coverage as the market would permit at an acceptable price, and on June 27, 2006, the Governing Board authorized placing the reinsurance.

This emergency arises out of that sharp increase in the cost of catastrophe reinsurance for the 2007 contract year. Because regulations require the Supplemental Limits Program to be financed separately from the base program, the Supplemental Limits Program's sharply increased reinsurance costs mean that Supplemental Limits Program premium revenue will not be received in sufficient time to allow the CEA to pay annual reinsurance premium installments when due. Without reinsurance, the Supplemental Limits Program cannot exist; and without the Supplemental Limits Program, the CEA believes that it would lose its key to policy sales.

CEA staff has determined that a two-step plan would allow the Supplemental Limits Program to continue: (1) Supplemental Limits Program rates would have to rise by 32.5 % over two years, and (2) to cover expense obligations until the full effect of the rate increase was achieved, the CEA would have to temporarily transfer capital from the base program to the Supplemental Limits Program.

On August 24, 2006, the CEA Governing Board approved such an application for a rate increase and also authorized the CEA to petition the Insurance Commissioner for a regulatory change to allow the emergency capital transfer authority required to continue the Supplemental Limits Program. The regulatory change must be completed before January 1, 2007, the effective date of the CEA's 2007 reinsurance contract. Otherwise, CEA will be forced to discontinue its Supplemental Limits Program coverages in early 2007, and all CEA policies that include Supplemental Limits Program coverages will be renewed with only base limits policy coverage. At the same time, the CEA will be forced to cease offering Supplemental Limits Program options to new and existing policyholders.

Justification for Adoption of Emergency Regulation

> "California's Administrative Procedure Act (APA) as codified in Government Code section 11340 et seq., vests a state agency with discretion to issue emergency regulations, which will become effective on an interim basis and for a period of up to 120 days, in order to deal with an 'emergency' which calls for prompt action during the period necessary for the promulgation of final regulations. (§ 11346.1(b) & subd. (e).)
>
> Section 11346.1(b) allows a state agency to promulgate emergency regulations as follows: '[I]f a state agency makes a finding that the adoption of a regulation or order of repeal is necessary for the immediate preservation of the public peace, health and safety or general welfare, the regulation or order of repeal may be adopted as an emergency regulation or order of repeal.'" *Doe v. Wilson*, (1997) 57 Cal. App. 4th 296, 305.

> "[T]he term "emergency" has been given a practical, commonsense meaning in the California case law: “[E]mergency has long been accepted in California as an unforeseen situation calling for immediate action. [Citations.] This is 'the meaning of the word that obtains in the mind of the lawyer as well as in the mind of the layman.'" *Id.* at 306.

In this case, the steep and sudden increase in reinsurance rates that developed in spring 2006 while the CEA was in the reinsurance market for 2007 is the "unforeseen situation" that compels immediate action. Because the reinsurance rates have jumped, the CEA must move quickly to ensure that the Supplemental Limits Program can continue.

It is estimated that just over 12% of California households have earthquake insurance. A decrease in this already low penetration rate would reduce the number of Californians able to afford to rebuild after a devastating earthquake. The CEA believes that the Supplemental Limits Program offerings drive policy sales of the base limits policy. This is why, in an effort to increase overall sales, the CEA has actively marketed the Supplemental Limits Program products. If the Supplemental Limits Program becomes unavailable, the CEA predicts it will lose a significant number of base limits policyholders, resulting in an even lower tally of Californians covered by earthquake insurance. In the event of a major earthquake in California, this reduction in policyholders would exacerbate the economic devastation caused by the earthquake.

Without amending the regulations, the CEA cannot transfer capital from the base program to the Supplemental Limits Program. And without such a transfer on a timely basis - which can be afforded only by emergency regulations - the CEA Supplemental Limits Program will end. Therefore, in view of the foregoing, adoption of the proposed regulations on an emergency basis is necessary for the immediate public peace, health and safety or general welfare of the people of the State of California.

Text of the Proposed Regulations to be Adopted

The proposed regulation text is attached.

PROPOSED TEXT OF AMENDMENTS TO CALIFORNIA CODE OF REGULATIONS, TITLE 10, CHAPTER 5, SUBCHAPTER 7.7[1]

Section 2697.6. Earthquake Policies, Coverage Types and Limits.

(a) The Authority must offer, in accordance with the provisions of Division 2, Part 1, Chapter 8.5, of the Insurance Code, a basic residential earthquake insurance policy to any owner of a qualifying residential property, as long as the qualifying residential property meets the eligibility standards of the Authority and the owner has first secured a residential property insurance policy from a participating insurer.

(b) The Authority must renew any basic residential earthquake insurance policy it has written, provided that the Authority receives payment of the applicable renewal premium on or before the expiration date stated in the policy. The Authority must nonrenew, rescind, or cancel a policy on the grounds that the qualified residential property is no longer covered by an underlying residential property insurance policy issued by a participating insurer.

(c) No policy issued by the Authority will provide coverage in the event there is no underlying residential property insurance policy issued by a Participating Insurer at the time of loss. In that case, any unearned premium shall be returned to the policyholder on a pro rata basis.

(d) The types and coverage limits of Authority policies shall be as follows:

1. Dwelling policy:	15% Deductible
Coverage A (Dwelling)	Equal to the Coverage A (or its equivalent limit) of underlying residential property insurance
Coverage B	Not available
Coverage C (Personal Property)	$ 5,000
Coverage D (Loss of Use)	$ 1,500
Coverage E (Limited Building Code Upgrade)	$ 10,000

The CEA may also, at its option, offer dwelling policyholders an additional $ 10,000 in coverage for Limited Building Code Upgrade.

2. Individual condominium or cooperative unit policy:	15% Deductible
Coverage A (Real Property)	$ 25,000
Coverage B	Not available
Coverage C (Personal Property)	$ 5,000
Coverage D (Loss of Use)	$ 1,500
Coverage E (Limited Building Code Upgrade)	$ 10,000

[1] Proposed amendments appear in underlined text and proposed deletions appear in ~~strickthrough~~ text.

Coverage F (Loss Assessment (condominium value > $ 135,000))	$ 50,000
Coverage G (Loss Assessment (condominium value </= $ 135,000))	$ 25,000 or $ 50,000

3. Renter's policy:	15% Deductible
Coverage A	Not applicable
Coverage B	Not applicable
Coverage C (Personal Property)	$ 5,000
Coverage D (Loss of Use)	$ 1,500

(e) In issuing its optional-limits basic residential earthquake insurance policies, the Authority must provide full financial backing in accordance with a written plan of finance. The plan of finance must operate effectively to protect policyholders of the Authority's base-limits residential earthquake insurance policies from any financial liability arising from any offer of policy limits in excess of the base limits. The plan of finance may include the purchase by the Authority of reinsurance and financial guaranty insurance on terms and at the limits that the Authority may find reasonable and appropriate, to secure the payment of claims obligations and expenses that may arise under its optional-limits basic residential earthquake insurance policy and related contracts of reinsurance.

Upon the governing board's approval in a written finding of an appropriate plan of finance that will protect policyholders of the Authority's base-limits residential earthquake insurance policies from any financial liability arising from the sale or issuance of a basic residential earthquake insurance policy with limits in excess of the Authority's base-limits policies and which will neither rely on nor impair the Authority's available capital, as available capital is defined in Insurance Code Section 10089.5, subdivision (b), the Authority may offer the optional coverage types and coverage limits in paragraphs 1, 2, and 3, below, subject to the provisions of Section 2697.4. Authorized intra-Authority transfers made pursuant to the provisions of Section 2697.61, subdivision (b), paragraphs (iii), (iv), and (v) are not and shall not be deemed reliance on or impairment of the Authority's available capital.

The optional coverage limits for Coverages C and D described in paragraphs 1, 2, and 3, below, are stated as gross limits that include the base limits provided in subdivision (d) of this section, and those portions of the gross limits that exceed the applicable base limits are to be written in excess of the base limits.

1. Dwelling Policy only: Optional deductible amount for Coverage A, and additional excess contents (Coverage C), and additional living expense (Coverage D) limit options. A dwelling policy that does not carry a 10% deductible must be issued at a 15% deductible. The lowered policy deductible and increased limits for Coverage C and Coverage D may be offered in any of the following amounts:

(i)	Optional decreased deductible	10% of Coverage A limit

(ii)	Coverage C (Contents)	$ 25,000, $ 50,000, $ 75,000, or $ 100,000
(iii)	Coverage D (Loss of Use)	$ 10,000 or $ 15,000

2. Individual Condominium and Cooperative Unit Policy only: Excess contents (Coverage C), and additional living expense (Coverage D) options may be offered in any of the following amounts:

(i)	Coverage C (Contents)	$ 25,000, $ 50,000, $ 75,000, or $ 100,000
(ii)	Coverage D (Loss of Use)	$ 10,000 or $ 15,000

3. Renter's Policy only: Excess contents (Coverage C) and additional living expense (Coverage D) options may be offered in any of the following amounts:

(i)	Coverage C (Personal Property)	$ 25,000, $ 50,000, $ 75,000, or $ 100,000
(ii)	Coverage D (Loss of Use)	$ 10,000 or $ 15,000

(f) For individual condominium unit policies and in accordance with its underwriting or eligibility guidelines, the Authority will issue earthquake loss assessment coverage in connection with its basic residential earthquake insurance policy for condominium owners in the amount of $ 50,000.00 (fifty thousand dollars) for a unit valued at more than $ 135,000.00 (one hundred thirty-five thousand dollars) and in the amount of $ 25,000.00 (twenty-five thousand dollars) or $ 50,000.00 (fifty thousand dollars) for a unit valued at $ 135,000.00 (one hundred thirty-five thousand dollars) or less. The value of the land on which a unit is constructed is to be excluded when determining the value of the condominium unit.

AUTHORITY:

Note: Authority cited: Sections 10087, 10089.5(c), 10089.11, 10089.20 and 10089.26(a)(1), Insurance Code. Reference: Sections 10089, 10089.11(a), 10089.28(b) and 12921, Insurance Code.

Section 2697.61. Additional Requirements for Offer of Optional-Limits Basic Residential Earthquake Insurance Policies

(a) Before the Authority can offer optional-limits basic residential earthquake insurance policies, the governing board must first certify that selling those policies furthers the Authority's charge in Insurance Code Section 10089.10 to achieve maximum capacity for writing earthquake coverage. The sale by the Authority of any optional-limits basic residential earthquake insurance policies must be actuarially sound and must neither rely on nor impair the Authority's available capital, as available capital is defined in insurance Code Section 10089.5, subdivision (b). The Authority is authorized to sell optional-limits basic residential earthquake insurance policies only to Authority policyholders, and only Authority policyholders are eligible to purchase the Authority's optional-limits basic residential earthquake insurance policies.

(b) All funds directly attributable to the sale by the Authority of optional-limits basic residential earthquake insurance policies must be maintained in accounts that are separate from the accounts maintained for funds attributable to the sale of base-limits basic residential earthquake insurance policies and must not be used to pay any obligations or expenses arising from the sale of base-limits basic residential earthquake insurance policies. The Authority must not use funds attributable to the sale of base-limits basic residential earthquake insurance policies to pay any obligations or expenses that arise out of the sale or issuance of optional-limits basic residential earthquake insurance policies.

(i) If, following the commencement of sales or issuance of optional-limits basic residential earthquake insurance policies, the Authority is unable to gain access to the financial backing for those policies that is outlined in the plan of finance specified in Section 2697.6, subdivision (e), so that it reasonably appears that the continued sale and issuance of those policies might financially burden the fund that provides backing capital for the Authority's base-limits residential earthquake insurance policies, the Commissioner may order the Authority to stop the sale and issuance of the optional-limits basic residential earthquake insurance policies until the Authority's access to the financial backing is restored and the Commissioner approves, by further order, a resumption of the sale and issuance of optional-limits basic residential earthquake policies.

(ii) If, following the commencement of sales or issuance of optional-limits basic residential earthquake insurance policies, the Authority is unable to gain access to the financial backing for those policies that is outlined in the plan of finance specified in Section 2697.6, subdivision (e), so that it is reasonably certain that the continued sale and issuance of those policies will financially burden the fund that provides backing capital for the Authority's base-limits policies of residential earthquake insurance, the Commissioner must order the Authority to stop the sale and issuance of the optional-limits basic residential earthquake insurance policies until the Authority's access to the financial backing is restored and the Commissioner approves, by further order, a resumption of the sale and issuance of optional-limits basic residential earthquake policies.

<u>(iii) Permitted, transfer of base-capital funds for optional-limits program financial support; required finding; reimbursement obligation. Upon a finding by the Governing Board that the Authority's optional-limits program has adequate financial backing, that the program is or reasonably can be made financially sustainable, that the program's continuation in existence is in the best interests of the Authority and its policyholders, that the program has rates in place or applied for that, as verified in writing by a qualified actuary hired by or employed by the Authority, are actuarially sound and reasonably calculated to financially sustain the optional-limits program, and that any such requested transfer will have no material negative impact on the</u>

financial stability or capacity of the Authority's base program, the Board may authorize a transfer of funds to any designated account of the Authority's optional-limits program from any designated account of the Authority's base program. Each such authorized base-capital-funds transfer shall be subject to full reimbursement by the optional-limits program within a reasonable period, not to exceed three years from the date of each actual transfer of base-capital funds. As a condition to any transfer, the Authority's chief financial officer shall certify in writing and provide to the Board at a public meeting the business need for the transfer and, in reasonable detail, the anticipated reimbursement terms and conditions, including a reimbursement schedule. Any known inability or failure to reimburse transferred funds in accordance with the authorized reimbursement terms, conditions, or schedule shall be reported forthwith to the Board by the Authority's chief executive officer, the chief financial officer, or the general counsel, each of whom shall have an independent duty to so report.

(iv) Annual Transfer Cap; formula for calculation maximum transfer of capital from base-limits program to supplemental-limits program; limitations. The funds transfers authorized by this subdivision are subject to an Annual Transfer Cap; as used in this paragraph, the "target calendar year" is the calendar year for which base-capital funds transfers are required to meet financial needs of the optional-limits program. The maximum amount of base-limits capital-funds transfer in or for a single target calendar year pursuant to the authorization for such transfer set forth in paragraph (iii) is the Annual Transfer Cap, which shall be calculated according to the following formula:

Annual Transfer Cap = P + (E/3) – (W/2) – C – (UEP/2) – (II/2)

Where:

P= Reinsurance premium by contract for the target calendar year
E= Estimated operating costs, supplemental program, for the target calendar year (includes (allocated) commission and fees payable to participating insurers and capital financing cost)
W= Estimated written premium, supplemental program, for the target calendar year
C= Estimated CEA capital attributable to supplemental program at January 1 of the target calendar year
UEP= Estimated unearned premium at December 31 for the year prior to the target calendar year
II= Estimated net investment income, supplemental program, for the target calendar year

All estimated amounts used in the formula must be confirmed by the Authority's chief financial officer as accurately determined and either based on or utilizing the reported, past figures for such costs, premiums, and capital that the Authority uses for its financial-reporting obligations. If so directed by the Board, the Authority during the target calendar year shall adjust the Transfer Cap as derived from application of the formula by the (1) substitution of revised estimates and actual figures, to the extent such actual figures are known, in place of the estimates called for by the formula and (2) recalculation of the resulting Transfer-Cap amount; in such case, the re-calculated Transfer Cap shall be and become, for all purposes and until any further Transfer-Cap adjustment , the maximum permitted transferred amount of base-limits capital for the calendar year. Any sums transferred in or for a target calendar year shall be limited to amounts reasonably calculated to accomplish the certified purpose(s), and no more, as calculated pursuant to paragraph iv, and in no event more than the annual Transfer Cap.

(v) Bar to capital transfer; expiration of authority to transfer capital. If the Board is informed in a public meeting by December 31st that the optional-limits program's gross costs and expenses associated with risk-transfer, such as costs of reinsurance, are reasonably likely to increase in the target calendar year by 50% or more over the present calendar year, the Authority shall make no transfer pursuant to paragraphs (iii) and (iv) of this subdivision. Notwithstanding any other provision of this section, the authority to transfer capital as provided in paragraphs (ii), (iii) and (iv) of this subdivision shall expire on December 1, 2008.

(c) Participating Insurers are permitted to offer their policyholders, or applicants for their policies, the Authority's base-limits basic residential earthquake insurance policy (1) without any optional coverage limits on that policy, if the Authority sells its optional-limits basic residential earthquake insurance policies by way of coverage-limits options on a single policy form, or (2) without making available the Authority's optional-limits basic residential earthquake insurance policy, if the Authority sells optional-limits basic residential earthquake insurance coverage by way of a policy form separate from that available for the Authority's base-limits residential earthquake insurance policy. No Participating Insurer is required to offer to its policyholders the Authority's optional-limits basic residential earthquake insurance policies, as long as the Participating Insurer continues to offer to its policyholders the Authority's base-limits residential earthquake insurance policy.

(d) An offer by a Participating Insurer of the Authority's base-limits residential earthquake insurance policy constitutes a mode of CEA Participating Insurer compliance with Chapter 8.5 (commencing with Section 10081) of Part 1 of Division 2 of the Insurance Code, and as set forth in Section 10084 of the Insurance Code.

AUTHORITY:

Note: Authority cited: Sections 10087, 10089.5(c), 10089.11, 10089.20 and 10089.26(a)(1), Insurance Code. Reference: Sections 10089, 10089.11(a), 10089.28(b) and 12921, Insurance Code.